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THE PREVENTION OF STOCK-WATERING BY PUBLIC-SERVICE CORPORATIONS

Public opinion is being educated by experience to a realization of the evil effects of leaving public-service corporations too much to their own devices. Flagrant and shameless attempts to water stock do not so easily escape detection as formerly. Yet there are subtle and elusive practices strongly suggesting stock-watering which may escape that scrutiny. It is the purpose of this paper to consider over-capitalization in some of its subtler phases, rather than in its grosser and more familiar forms.

A public-service corporation is in its nature subject to stricter regulation than an ordinary commercial monopoly. The attitude of our institutions permits the fullest freedom to all commercial enterprises and carefully avoids interference with their profits except for the purpose of checking practices in restraint of trade. Unless public rights are seriously invaded by interference with trade or by frauds on the investing public, it is to be expected that wide liberty will be allowed all ordinary commercial monopolies in the methods of conducting their finances. A public service corporation, on the other hand, is subject to stricter regulation than a "trust," because it is a public servant, and as such has special responsibilities and obligations. If it is inefficient in discharging its duties it should be dealt with as drastically as any incompetent public official; while if it is efficient it should be permitted every reasonable privilege and every legitimate opportunity which may lead to increased profits. The only way in which such increased profits may legitimately be earned is by an exceptional degree of skill in furnishing the public with superior service at minimum prices. If these general principles are borne in mind, many problems which have heretofore been confusing will become simplified.

In Massachusetts, where the regulation of public utilities has reached a high standard, the advantages of limitation of capital are to some extent offset by the policy of sanctioning high dividends. Dividends of gas and street-railway companies in Massachusetts are much in excess of an equitable rate fair alike to the public and to the corporation. The average dividends of the six leading Boston companies involved in last year's gas consolidation, for the year

ending June 30, 1904, were 7.6 per cent. The average for the gas companies of the entire state is about 7 per cent., while street-railway dividends in the larger cities are in the neighborhood of 7 and 8 per cent. It is easily shown that there is no justification for such high rates. The policy of monopoly has been uniformly acted upon by the Massachusetts Gas Commission, although the legislature has on a few occasions departed from it, and is established with such firmness as to minimize the risk of competition. In street railways, the tendency toward combination and monopoly has prevailed over that toward competition, so that the prosperity of a Massachusetts street railway, once established in a good field, is a foregone conclusion. While it is not denied that at one time there may have been a speculative risk in these enterprises, there has been no such risk for many years, except of course in the case of many such corporations located in rural or undeveloped territory. Capital could readily be secured at 4 and 5 per cent. in the open market on what would be considered a good investment.

These remarks apply to the general situation throughout the country as well as to Massachusetts. Everywhere dividends are higher than in the case of private business corporations where the risks are correspondingly small. The policy of monopoly everywhere prevails—or is coming to prevail—and franchises, at least during good behavior, are practically exclusive. Under such conditions, it is only in exceptional instances, as where the territory is undeveloped, that there is any risk to the capitalist. Ten years ago Mr. Edward E. Higgins, the well-known expert in street-railway matters, wrote that street-railway properties in the largest cities were "among the safest and most profitable in the entire range of capital investment."¹ It is needless to add that the growing tendency toward centralization of recent years has had the effect of rendering them more rather than less safe.

It is perhaps to be desired that the policy of a monopoly secure during good behavior be enacted into law, for were corporations thus secured against competition their capitalization on an investment basis more advantageous to the public might be brought about. Were states to make monopoly legally binding, as Massachusetts has by its laws made it virtually binding, they might properly at the same time limit dividends to 4 and 5 per cent., except where it could be shown to the satisfaction of a state board

¹ E. E. Higgins, *Street Railway Investments*, p. 81.

that special risk would be assumed. Such a measure would be an important gain for the cause of reasonable prices for public utilities. Admittedly public opinion is not ripe for such a compulsory reduction of dividends. At the same time dividends everywhere are much too high. They are, in fact, a survival of the *régime* of competition, with its great risks, and of the period of development, in which the profits likely to accrue from new forms of industry were very uncertain. Those risks and uncertainties have now in large measure disappeared, but the public still meekly submits to dividends of 8 and even 10 per cent.

A policy which permits high dividends is in effect a sanction of undue profits. While fair compensation should be allowed the capital employed in a public-service corporation, the corporation should not be permitted to exploit the public like an ordinary industrial enterprise. In states where capitalization based on earnings, as in New York, New Jersey, Delaware, West Virginia, Illinois, and many other states, is tolerated, the evil of public exploitation frequently becomes flagitious, but in states like Massachusetts, and perhaps Connecticut and Nebraska, where capitalization based on assets is preferred, the excessive earnings are as truly there, though they may not be as effectually hidden and clandestinely swollen by watered stock.

Far more important, however, than the limitation of dividends is the restriction of capitalization to legitimate proportions. The evil of over-capitalization is not secondary to that of mismanagement, but is perhaps more serious. An over-capitalized company is always a spoliator of the public, but a mismanaged one will seek from self-interest to remedy its mistakes, if it is denied by the state the privilege of doing whatever it pleases. The restriction of capital is entirely proper and is based on entirely different principles from those governing the relations between the state and private corporations. It is made not in pursuance of a general policy relative to the finances of all forms of corporate enterprise, but simply in the interest of the public for the purpose of securing legitimate prices for public utilities, that is, prices based on capital actually requisite and on services actually rendered. The peculiar relation subsisting between public service corporations and municipalities renders such limitation of capital not an unjustifiable interference with business enterprise, but simply an application of the common statutory principle that in a matter involving the disposition of its own

franchises the public has the right to make a contract on such terms as it chooses.

There are two commonly received theories as regards the proper capitalization of public-service corporations. The first of them permits capitalization based on earnings, and is accepted in many states in this country, and by public-service corporations in England to the extent at least of making the capitalization of the net profits of a gas company its legal value for the purpose of purchase.² In England the adoption of this theory for gas companies has not resulted, it would seem, either in vicious over-capitalization or in exorbitant charges to the public. The fact that it has not is to be attributed to the sliding-scale system and other checks on corporate avidity. It is to be presumed that a company limited to dividends of 4 per cent. when gas is sold at 3 s. 9 d., and entitled to earn 5 per cent. only when the price is reduced to 2 s. 11 d., like the London Gas Light & Coke Company,³ will find no incentive to increase its capitalization to excessive proportions, for the effect of over-capitalization would be to lessen rather than increase the possibility of dividends of 5 per cent. or more. The net profits of such a company, so long as it does not resort to illegitimate expedients of concealment of profits—and such expedients are perhaps unlikely to be crowned with any considerable success—will of course be moderate, and a capital based on such income will be moderate. Such a system of regulation undoubtedly has many strong points, and it can be profitably studied. The adoption of the sliding scale in this country will doubtless remedy many of the abuses of over-capitalization.

In this country the principle of capitalization based on earnings has had an effect the very opposite of that in England. Its adoption has concealed from the public the results of cheapened processes of manufacture, and has disguised exorbitant profits which, if they had been known, would have given rise to public scandal. Prices have been swollen by extortionate dividend-charges, and the true financial status of the corporations has been hidden from view. Whatever merits the system may have in England have been lost in the United States by the rejection of the sliding scale. More-

² Walter S. Allen, "The Gas Supply and The Public," *Municipal Affairs*, Vol. VI, p. 662, 1902.

³ For sliding schedules of the London gas companies see *Annals of the American Academy of Political and Social Science*, March, 1905, p. 124.

over, even in England, the system is perhaps not quite perfect, for it seems to be open to the objection that the adjustment of capitalization to actual value of plant is approximate only, and brought about by indirect means, and that the public can never know how accurate it is. The chief advantages of the plan of capitalization of net profits, under the restraint of a sliding scale for dividends, would seem to be secured, and its chief defects avoided, by capitalization on the basis of the value of the property of the corporation.

The rule that the capital stock of a public-service corporation should stand in a close relation to its actual assets, if not explicitly stated by the Supreme Court of the United States, finds at least some indirect support from its decisions. The authority of this court is clearly on the side of the view that a public service corporation has no right to charge unreasonable prices which are large by reason of dividends on watered stock. Thus it was decided in *Covington and Lexington Turnpike Road Co. v. Sanford*, 164 U. S., 596, that "The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends." In *Smyth v. Ames*, 169 U. S., 544, the court ruled that "If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is largely fictitious, it may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization." The trend of these decisions is obvious.

Apart from the question of legal authority, however, there can be no doubt of the superiority of the assets-capitalization theory over that of capitalization of income. The determination of the value of assets, however, presents some difficulties. Professor Ripley names four methods of determination, based on original cost, cost of reproduction, "structural value," and market value.⁴ Which of these four methods is to be preferred is a question which we will not now discuss, confining our attention to the value-of-assets theory itself, which is far from being in every way satisfactory.

A little reflection will show that the value-of-assets theory may become a cloak for excessive capitalization. The assets of a public service corporation may consist of a large amount of property, in the form of real estate or superfluous equipment, which it does not require and which it holds partly, perhaps, with the hope of being

⁴ Z. R. Ripley, *Trusts, Pools, and Corporations*, p. 130.

more strongly fortified against competition; partly to serve as a convenient pretext for stock-watering. Such extra property may have been accumulated in a variety of ways. Commonly it is the result of appreciation in value of real estate, or has resulted from the accumulation of an excessive and needless surplus from profits. Usually a corporation will pay for improvements of its plant entirely from its earnings, instead of seeking funds for that purpose by converting into cash property which it no longer requires. The temptation to pursue this method is especially strong where the capital stock is not large and the earnings are great, and it becomes problematical in what way the profits are to be disposed of. Again, the accumulation of superfluous assets may have come about through a process of consolidation of two or more companies, as in the case of the recent Boston gas consolidation, where four disused gas plants with which the new corporation might well have dispensed, came into its hands. The wastes of competition, alike in gas and street railway companies, give rise to an excess of assets when two duplicating plants are merged which should not serve as the basis for an issue of capital stock. To permit the excess to be capitalized has precisely the same effect on the public as the issue of an equal amount of capital where there are no visible assets on which to base it. If in the former case the extra stock would not be called water as in the latter, it is equally true in both cases that dividends have to be met by the public on capital which is not necessary to the proper conduct of the affairs of the corporation, and that a convenient outlet is provided for profits which the public has the right to have applied to the reduction of prices.

But the policy of treating the value of assets as the basis of capitalization may operate to the disadvantage of the corporation as well as of the public. Thus a writer objected to the Massachusetts law on the ground that it deprives gas companies of the capital necessary to prevent them from getting into a rut and to enable them to introduce modern methods that will bring about lower prices.⁵ This criticism is not altogether fair, because the profits of companies are ordinarily large enough in Massachusetts to enable them to make fairly extensive improvements if they desire; and one of the reasons why such improvements are not made is the avidity of the companies in maintaining excessive dividends on their capital stock. But it must be admitted that under the

⁵ See article by Charles G. Dawes, *Saturday Evening Post*, January 28, 1905.

policy of denial of needed capital for which there are no assets a gas company may be seriously hampered. A company which has practiced a rigid economy, yet has failed to cheapen gas manufacture by introducing modern appliances, may desire to improve its plant. Or population may have increased to render advisable a considerable extension of the plant. Under such conditions, to deny the company an increase of capital on the theory that capitalization should never exceed value of assets is to hamper efforts which have a praiseworthy object. While public-service corporations should set aside a large amount of their income each year for depreciation and improvements, it is obviously unreasonable to suppose that all funds for extensions of plant and equipment should be secured in this manner.

The adoption of the principle that capitalization should be based upon the amount of property reasonably necessary for the performance of the public service in question would put an end to the evil of capitalized surplus, and would also grant all the capital legitimately required. This view that capital should be based, not on the property actually held, but on that required, may seem somewhat novel, but it is doubtless well justified. As a matter of fact, state boards have to act upon some such principle when they grant a petition for an increase of capital stock on the ground that it is reasonably necessary for the purpose for which it is sought. Such a principle is just both to the corporation and to the public. In the interest of the public, it is desirable that the corporation should not be permitted to earn profits disproportioned to the public service that it is rendering, but that its profits should stand in a reasonable ratio to the volume of its business. Public policy therefore demands that public-service corporations be denied the privilege of earning profits upon property which could be dispensed with. The only way to do away with such profits is to prevent the capitalization of such property. Moreover, such capitalization being prevented, a company will find it less to its advantage to accumulate a surplus, and will more readily seek to apply every possible effort to maintain its plant and equipment at as high a grade of efficiency as possible, instead of suffering a large amount of superannuated fixtures and abandoned real estate to tie up funds that should be used for improvements needed to keep the property up-to-date.

One has only to consider that a public-service corporation is entitled only to profits actually earned by the skill with which it

performs the service, to see that the capitalization of superfluous property has about it an element of stock-watering. There are, in fact, no legitimate earnings, apart from the question of legitimate assets, to justify such over-capitalization. What right has the company to earn dividends on capital which is not employed in the service of the public?⁶ It secures the income for such dividends simply by mulcting the public, and this income, even on the income-basis-of-capitalization theory, should not be allowed to serve as a pretext for a large capitalization, for it is wrung from the public simply by a process of extortion, and is by no means to be regarded in the same light as similar gains secured by a private monopoly. The private monopoly may be morally entitled to profits which, simply because it is a monopoly, swell to large proportions; but the public monopoly is not purely and simply a commercial organization, but a voluntary servant of the public accepting a public trust. As such, it cannot maintain needlessly high prices without incurring the reproach of ignoring its true function and neglecting the duty which it owes to the public. And if it is morally entitled to earn an income only on capital actually required, it is under a still greater obligation to refrain from capitalizing the property from which an unearned income is derived.

Capitalization based on legitimate assets may seem to present some difficulties arising from the chance for a difference of opinion regarding what assets are legitimate and what are not. The way in which these difficulties can be overcome—and it is believed that they are not serious—cannot be discussed here, for it is the purpose of the present article to point out objectionable practices and to suggest objects at which remedies should be directed, rather than to describe the remedies themselves. The machinery of state regulation would require special treatment to be presented at all satisfactorily. What systems of expert inspection and appraisal should be established, and on what basis value should be determined, should of course not be treated carelessly. As regards the latter question of determination of value, it will be sufficient to indicate in this place two or three rudimentary propositions. First of all, a corporation should not be made to suffer on account of fortuitous fluctuations in the market price of the materials from which its plant

⁶ For the late Dr. Charles B. Spahr's opinions on the "extortion" practiced through street-railway fares "to pay interest on capital never lent to the public," see *The City of the People*, by Frank Parsons, p. 216.

and equipment have been constructed. If a street railway has been constructed, for example, when steel rails cost \$35 a ton, and years afterward, when the market price has fallen to \$26 a ton, is threatened with a burdensome restriction of capital on account of the fall in market value of its structural materials, it is unjust to make the company suffer for that for which it is in no way responsible. If a company has permitted its equipment to get badly out of repair, that is of course an entirely different matter. While depreciation due to wear and tear should be deducted from the original investment, depreciation due merely to fluctuation in price should never be. The second proposition is this: a valuation based on the present cost of reproduction fails to make allowance for depreciation, and sets up a false criterion of value in so far as it attributes the marked advantages of an entirely new plant to one which has the disadvantages arising from many years of use. Even if the loss through depreciation has been made good by progressive improvements from earnings, it is obvious that the reduplication value of such an improved plant will be in excess of its structural value, for the reason that depreciation must be overlooked. Thirdly, a forced sale is of course no fair test of value, and the latter is less accurately determined by reference to market value than to those things upon which market value is based. These considerations which have been thus briefly presented may suggest the view which is presented as a plausible assumption rather than a verified statement, that the true criterion of value is original structural cost less depreciation. Such a view is somewhat loosely put, but may not be far from the true principle, which may perhaps require that the structural value of plant and equipment—their adaptability for present use—be taken as the true basis.

The last principle, of course, is by no means the one commonly acted upon. The cost-of-reduplication theory is, roughly speaking, the one usually accepted by the courts. The adoption of the view, however, tends to bring about over-capitalization. For this mode of appraisal is open to the objection that in many instances it permits the issue of a much larger capital than the structural value of the property, were capitalization to be based upon that, would justify.

Assuming, then, that capitalization is to be based upon structural value, we are driven to the conclusion that it must be upon structural value only of the property necessary for the purposes in which

the corporation is employed. This being the case, every attempt to secure a larger capital must be looked upon as pernicious. But if capital is to be thus adjusted to necessary assets, a system of effective state control is required by which capitalization can be either increased or diminished as the judgment of an expert administrative board may determine.

The proper mechanism which should be adopted for such control is a topic beyond the province of the present discussion. In general, however, it may be pointed out that an increase of capital should be granted when shown to be reasonably necessary for an expenditure for construction which the corporation cannot justly be asked to meet from its earnings. Before granting such an increase, however, it should be ascertained whether the corporation has unused property on its hands which can be dispensed with and converted into cash, and if so, the estimated proceeds of such property should be deducted from the increase of capital.

Any effectual system of control should provide, however, for reductions of capital as well as increases. When there is reason to suppose that capitalization is excessive, the state should carefully examine the affairs of the corporation, calling upon it, if necessary, to produce its books, and should, if it believes the situation warrants such a procedure, notify the corporation to call in a certain amount of stock within a reasonable time. If the company should not comply, there is a remedy which is certain to prove efficacious. If a company is over-capitalized it is in a position in which it is ill fitted to resist the competition of a rival company with a reasonable capitalization, for the rival can maintain lower prices on an equal margin of profit. A corporation, therefore, may be brought to terms by threatening it with a withdrawal of the privilege of monopoly, which should be allowed it only during good behavior. If it is obstinate, it is for the interest of the public to permit a rival to enter the field. To avoid, however, the wastes of competition, it is desirable that the rival be given the right to purchase on behalf of the state, by eminent domain, such of the properties of the older corporation as it may wish to secure. There can be no doubt that such a device, by which with the permission of officers of the state such new companies could be organized under general laws to buy out and wind up old companies unmindful of their public duties, would operate as a strong deterrent to prevent the over-capitalization of public-service corporations. Such drastic action need

involve no impairment of contract on the part of the state, for the latter in its grants of corporate powers may make such reservations as it feels to be required for the public interest.

The writer believes that a practical remedy for the evils of stock-watering is to be found in the passage by the states of general legislation applying specifically to public-service corporations and defining accurately their privileges and obligations, as contradistinguished from those of private-business corporations. Such legislation would tend in large measure to correct the common misconceptions by which the radical differences between the two classes of enterprise are obscured. It would also set before the officers of the state a clearly defined, comprehensible statement of policy to serve as their basis for quasi-judicial determinations of proper capitalization and dividends, fair prices, and what not. The serious trouble now is that even under progressive policy such officers are left too much to solve these vital problems in accordance with any passing whim. But so soon as the more progressive of our American commonwealths can muster up courage to defy the powerful corporations and pass the legislation which the people, if time is given them, will come to support with enthusiasm, the solution of a formidable municipal problem will be in sight. The vital need of the hour is more than anything else a scientifically defined policy on the part of the state in the matter of capitalization of these particular corporations, and self-respecting legislators of ability and character can safely count on popular support in their attempt to secure the adoption of some settled programme.

ARTHUR W. SPENCER

BROOKLINE, MASS.